Regulatory Policy Institute rpi

STREAMLINING REGULATORY AND COMPETITION APPEALS

Response to the BIS consultation of 19 June 2013

Introduction

In 2012, supported by a secretariat at the Commonwealth Department of Resources, Energy and Tourism and by Dr Chris Decker, then of the Regulatory Policy Institute, Oxford, we conducted a review for the Australian federal and state governments of the Limited Merits Review regime (the "LMR") in Australia for appeals of energy network decisions made by the relevant regulator. The LMR regime had been introduced in 2008 with an intention to streamline appeals procedures. Our Review extended over a six month period and was based upon: written submissions, mostly in response to two 'Issues Papers' (consultation documents) that we published; an extensive series of meetings we held with interested parties, including consumer representative bodies, companies, regulators and government departments; detailed analysis of the *substance* of the individual cases that had passed through the new system; a study of appeals systems in overseas jurisdictions; and a study of the role and scope of Australian administrative tribunals in reviewing other types of administrative decisions 'on the merits' . In consequence, we collected a considerable body of evidence.

The relevance of this material to BIS is that, in an institutional context which is about as close to the UK's as it is possible to find in an overseas jurisdiction, policy makers had wrestled with the very same trade-offs that underlie BIS's consultation document, had alighted on a set of arrangements intended to 'limit' the amount of resources, including time, devoted to merits review (hence "LMR"), and had subsequently observed an unexpected surge in the number of appeals, and hence of the level of review/assessment activity. That is, *what happened was almost exactly the opposite of what was intended to happen*. It was the fact of this observed, substantial increase in appeals activity, coupled with the fact that appeal outcomes consistently led either to no change in network charges or to increases in those charges (and hence, ultimately, to significantly higher retail prices for electricity and gas), that led to the commissioning of our review.

Looking at matters in retrospect, with the benefit of the evidence before our eyes, it was not difficult for us to understand how these unintended consequences had come about. We, therefore, make this brief submission in the hope that it will help BIS avoid making some of the same mistakes and then subsequently finding, as the economic evidence on the effects of regulation so regularly finds, that outcomes are radically different from those intended. The submission is focused on a relatively small number of skeletal points.

More specifically, whilst noting that the consultation document makes explicit reference to our review at paragraphs 4.12 and 4.13, and whilst the reference to our concern about neglect of consumer interests in the Australian appeals process (at paragraph 4.12) is a correct one so far as it goes, this short summary is misleading in that it fails to draw attention to the fact that our own key

findings directly contradict some of the main propositions set out in the consultation document, upon which BIS's subsequent reasoning and conclusions are based.

The purposes of merits appeal

Merits review is a well-established feature of the Australian system of government. It is focused on providing supervision of administrative decisions via recourse to non-judicial tribunals because, as noted in the 1971 Kerr Committee Report, *"the vast majority of administrative decisions involve the exercise of a discretion by reference to criteria which do not give rise to a justiciable issue. It follows that for constitutional reasons there can be no review by a court on the merits of these decisions unless those criteria are changed appropriately so as to raise justiciable issues"*.

The function of the various administrative (non-judicial) tribunals has been described by Justice Garry Downes, a former President of the Administrative Appeals Tribunal, the top-level administrative tribunal in the Australian system, as follows:

> *They reconsider the decision under review and determine whether it is the correct or preferable decision. Correct, when there is only one decision; preferable, when a range of decisions is available.*

We consider the implicit distinction between different types of decision to be relevant here. When dealing with, say, a question of whether or not a particular supplier or group of suppliers has infringed competition law, the decision is primarily binary in nature – is there an infringement or not? In Downes's sense, there is only one primary decision, even though there may also be consequential questions about the seriousness of the infringement, for example when determining financial penalties, which involve assessment of a range of possible alternatives. Although it was not central to our own remit, we did to some extent consider issues surrounding binary decisions and did not find any substantive evidence that the relevant appeals body, the Australian Competition Tribunal (the "ACT"), faced significant difficulties in assessing decisions of this (binary) type.

Our own task was to examine cases where the relevant regulator could potentially have come to a range of potential decisions, exemplified by, but not restricted to, price control decisions. It was for such decisions that we found there existed major defects in the newly established LMR regime.

The judicial-review-only option

In response to these identified defects – the most important of which will be summarised below – we considered the possibility of recommending the abolition of merits review altogether and, instead, relying only on judicial review to provide checks and balances on administrative decisions. In the event, we rejected that particular option.

Judicial review focuses on identifying major defects in the process of arriving at an overall decision, but it will only tend to improve the decision from a public policy perspective where there is some correlation between the defects in process and the 'quality' of the eventual decision (i.e. fewer defects are associated with better decisions) measured in terms of its contribution to the relevant policy objectives. Such a correlation exists in some circumstances, but it does not in others.

One way of looking at the matter is to say that judicial review is focused on the *inputs* to the decision, not the decision's *outputs* (its implications for public policy). A reliance on assessing inputs alone is only warranted if there are very rigid links between inputs and outputs (as there might be, for example, between the inputs and outputs of a particular *physical* process – e.g. a version of the internal combustion engine), but such rigidity is not a characteristic of decision making processes. Devoting sufficient resources to reduce the threat of adverse judicial review to low levels, by exploring every imagined possibility and ticking every conceivable box, is likely to lead only to protracted, inefficient and burdensome (on others) regulatory processes, and hence to bad decisions (not necessarily wrong decisions, although there is no guarantee of higher quality from ever increasing input levels (see 'too many cooks spoil the broth'), but rather egregiously inefficient decisions). This is not how parliaments intended price cap regulation to be, either in Australia or in the UK.

Since judicial review is ever present – the only question facing us was whether merits review should also be available as well – it seemed to us difficult to see any good reason why, in establishing arrangements for supervising the decisions of administrative agencies, Australian governments should wish to forgo the opportunity of assessing the actual quality/merits of the decisions themselves. Such forbearance would, in effect, be equivalent to a decision to turn a blind eye to relevant information on outputs or outcomes of decision processes. Moreover, to shift back to 'input-focused regulation' would be out of step with contemporary regulatory developments and practice in other areas of economic and social life.

Precisely because it does not focus on the merits of the actual, relevant decision, we were also concerned that reliance on judicial review only implies that in those cases where the original decision is held to be defective the matter is remitted back to the relevant regulator. Whilst this has some potential advantages in that it ensures the eventual decision is taken by the institution where most specialist expertise is likely to be concentrated, it does mean extra delay, possibly of considerable duration (depending on the nature of the defects found). In any event, we noted that this is not an argument against merits review since (a) merits review encompasses the possibility that the appeals body can remit matters back to the regulator (as well as the possibility of substituting its own decision in those cases where it believes that matters are sufficiently clear cut for it to be able to do so without major risk), and (b), if substitution of the appeal body's decision for that of the primary regulator is a major concern, it is possible to establish a merits review system which *requires* that matters be remitted to the primary regulator, as a matter of course, when the decision is found wanting. We pointed to the Aviation Appeals Panel in the Republic of Ireland as an example of this latter approach.

During the course of the review there were some complaints from interested parties about the length of time the ACT took to complete some (though far from all) cases. However, judicial review cases can themselves take many months to complete, and there appeared to us to be no obvious advantage in terms of length of the review period. Moreover, as already indicated, the fact that judicial review can only block decisions, and cannot end a case by substituting a preferable decision as administrative tribunals can, is a feature that can be expected to increase the average time taken to reach final, lawful decisions.

Problems with the notion of 'error correction'

Returning to the defects we found in the attempt to limit the scope of merits appeal decisions, the most important of these were connected with a focus on error-correction in the appeals process. We therefore note the potential for repetition of the same mistake in the UK context, since in the summary of the case for change made at the beginning of Chapter 3 there is an indication that the Government is contemplating making appeals "more focused on identifying material errors."

For decisions that are determined by the combined effects of potentially numerous sub-decisions and judgments – and again price controls are the most obvious example – it is likely that, in very many cases, more than one 'error' will be made along the way. Indeed, and we speak with practical experience of large, administrative organisations, the errors/biases will likely be in sufficient numbers that, if there is absence of overall organisational bias (and that can be a big 'if'), there will often be a certain amount of self-cancelling in terms of directional influences on the final, overall decision. An analogue here is measurement error in scientific experiments: multiple random errors lead to a small, overall average errors. It is a tendency recognised in price control determinations themselves, where 'swings and roundabouts' judgments are frequently made in the interests of administrative expediency and to lighten the regulatory burden.

It can be conjectured that the LMR regime's focus on correction of errors made in the process of making regulatory determinations, whether they be errors be errors of fact, law, reasoning, judgment or whatever, reflects an attempt by the drafters of the legislation to make relevant matters justiciable (see the Kerr Report citation above). That is, at least implicitly, the LMR might be said to have changed the relevant decision criteria so as to make appeals capable of being handled by an existing institution (the ACT). Put another way, policy substance (to arrive at the best or most preferable decision, judged on the basis of policy objectives) was, to at least a degree, subordinated to process considerations (that the decision be free from material errors).

It is also likely that those responsible for including a focus on error correction in the legislation operated on the basis of the view that, if errors are reduced, it can be expected that the decision will generally be improved in consequence. We found this fallacy to be widely held among interested parties, perhaps because it can be true in some specific circumstances, even though it is false in general. For example if all errors were eliminated, or if the appeals process randomly eliminated the most significant of the random errors made by an unbiased organisation, it might be reasonable to expect that decisions will be improved. We suspect, however, that such circumstances are very rare, and they were certainly remote from the Australian energy sector context, where we found that attempted 'error correction' via the appeals options had been subject to strong bias (see below).

In general, there should be no general expectation that simply correcting some errors will lead to a better overall decision; particularly when the error-correction processes are very far from random (and see further below on why they are not).

Strategic influence and biased incentives

One of the two main defects that we found in the error correction approach was that it allowed appellants to influence appeals outcomes, giving rise to a form of bias that is very familiar in the economics of regulation. By focusing on a particular error or defect in the decision making, and because the ACT had difficulties in taking account of issues other than those raised in the appeal (because the merits review was intended to be 'limited'), an appellant was able to influence the scope of the subsequent review. In so doing, the review could be so managed that the ACT focused on those errors whose correction would favour the appellant, but was not able to take account of other possible errors whose correction would have had exactly the opposite effect.

We say "appellants", but in practice the appellants were typically the monopoly network operators, who not only had much more at stake in particular decisions than individual customers or consumers, but also had the resources to be able to cope with the complexities of lodging appeals within the relatively short time windows allowed by the LMR arrangements following an initial decision. Thus, whilst the bias toward excessive appeals activity was inherent in the LMR regime itself, the anti-consumer bias was more specifically the result of an imbalance in resources that was leveraged by tight time constraints. In consequence, the reviews conducted by the ACT were dominated by the agendas of one set of interested parties (the network companies), argued out in adversarial ways by lawyers, with little or no consideration given to the interests of consumers (which are the high-level purpose specified in the Australian National Electricity Objective and National Gas Objective). Notwithstanding the clear legislative specification of these consumer-focused objectives, which are intended to govern not only the decision making of the primary regulators but also of the ACT when it is making merits review decisions, they got very little look in during the review process: they were simply not a major concern of that process.

This is the finding correctly noted by the BIS consultation document at paragraph 4.38, but what is more important is the underlying causality: *it was the attempt to limit the grounds of appeal and the scope of reviews that caused the problem*, and we are concerned that BIS may inadvertently promote similar outcomes in the UK if the importance of having the possibility for *unconstrained* 'second looks' at significant problems is not recognised. It is the existence of constraints on review processes that gives rise to strategic manipulation of such processes – in the Australian case leading to excessive appeals activity that gave inadequate attention to the interests of consumers – and our own proposals were therefore aimed at reducing those constraints, not increasing them.

Cumulative effects of multiplicities of judgments

The second major defect we found with the error correction philosophy underlying the LMR regime (and also with the 'judicial review only' alternative), at least in relation to the complex, non-binary decisions with which we were concerned, is its weakness in addressing bad decisions that are built up from, or justified on the basis of, a whole set of subsidiary decisions and judgments which are influenced by systematic (rather than random) errors and biases. Most usually the problematic biases are caused by common factors such as particular features of organisational behaviour and organisational culture in the relevant decision-making context. That is, organisations develop ways of seeing the world which can be self-sustaining over quite longer periods of time, and relatively

insensitive to the evidence around them, even when, and sometimes perhaps because, these perspectives are quite misguided.

Examples in the Australian context included (a) a firm belief by the Australian Energy Regulator that it was constrained to an assessment approach that required final judgments about price controls to be mechanistically derived from simple adding up of line-by-line or component-by-component estimates of costs, which encouraged challenge on the basis of detail rather that the overall merits of decisions and was not, in fact, explicitly mandated in the National Electricity and Gas Laws, and (b) an unwillingness of the ACT to consider the policy implications of what it was doing when, having found that a particular decision was defective on specified, narrow grounds, it went on to substitute its own 'top-level' decision – an administrative decision that should properly be a reflection of a wide range of factors, not just those considered in a highly limited/constrained review process – for that of the primary regulator.

Common cultures and common views of the world can, of course, serve useful co-ordination functions in economic systems, but they can also render them blind to certain obvious features of the decision contexts in which they may find themselves operating. The blind-spots tend to be increased in size, and conduct rendered more stubborn in nature, by the fact that, in making decisions, regulators themselves are typically exercising substantial market power: for example, a regulator making a price determination is, in setting a monopoly price or price cap, substituting public monopoly for a private monopoly. In general, we can expect that monopolies (of all types) have, for want of strong incentives to stay focused on the interests of those they serve (whether customers or the public), tendencies to see things in ways that suit their own interests or prejudices. It is for this reason that recourse to a second, independent pair of eyes, expert enough and with sufficient resources to conduct a relatively unconstrained 'decision audit' on the necessary scale, is an important component of a well-functioning policy system. In its absence, blind spots and stubbornness can proliferate.

It is intrinsic to judicial review that it cannot easily address decision making failings that are the result of systematic cumulations of small biases. In major decisions such as price controls regulators exercise discretion in relation to each of a large number of 'judgment calls' about factors that are relevant to the overall, or 'top-level' decision. None of the individual judgment calls may have a material effect on the top-level decision, but a biasing influence that is common to the sub-decisions on which a top-level decision will be based can nevertheless lead to manifestly poor decisions.

Merits review is intended to avoid this problem by focusing on what actually matters, the quality of the overall/top-level regulatory decision. We concluded that, in Australia, the problem had not been avoided because the constraints placed on the review process, with the intention of streamlining it or reducing the resources (including time) allocated to appeals, had *in effect*, subverted review on the merits, by redirecting assessment away from the merits of regulatory decisions themselves and toward assessment of possible errors in the many *inputs* to those decisions. As indicated above, the result was a bias toward excessive appeal activity on the part of regulated energy network businesses, since the limitations placed on reviewers meant that these expert and well resourced appellants could exert some degree of control over the matters that would be considered, and could

search among the many components of the regulatory decision making process to find those matters that, if re-considered, could lead to maximum expected benefits for the appellant.

A few detailed comments on the BIS document in the light of the above

In the Foreword to the consultation document the Minister says that:

In the communications sector in particular, the Government is concerned that appeals may sometimes be seen as a one-way bet, and a chance to re-open regulatory decisions, encouraging lengthy and expensive litigation and holding back decision-making.

The Australian experience confirms the importance of avoiding an appeals structure that can lead to incentive structures that approximate 'one-way bets', and we agree that this is a major issue. However, the Minister's specific reference to communications is, we think, important. The evidence does not support the view that the potential problem identified goes any wider than communications.

During the course of our review, we naturally compared the LMR regime in Australia with approaches in other countries, including continental EU member states, Ireland, the United States and the United Kingdom, giving particular attention to the UK because of the background similarities in regulatory approaches. This particular attention involved looking at other sectors, as well as the energy sector to which the LMR applies. We noted the much lower level of appeals activity in the UK than under the LMR regime, not only in energy but in other sectors, *with the exception of telecoms*.

This inter-sectoral pattern is consistent with our conclusion that it is *constraints* on reviewers – which have the effect of limiting reviewers' ability to examine potentially important aspects of relevant decisions (what we referred to as 'no go areas') – that are central to establishing 'one-way bet' incentives, and hence encouraging excessive levels of appeal activity. Given that the effect of the communications appeals processes in the UK has been to constrain the freedom of the Competition Commission to assess Ofcom price control decisions – matters being filtered through the Competition Appeal Tribunal, according to a prescriptive/constraining process – a higher level of appeals activity for communications sector price control decisions is exactly what we would expect to find. Moreover, it is only in relation to telecoms price controls that the frequency of appeals (reported as seven out of nine, or about 77%) gets anywhere close to the LMR level for Australian energy networks (100% for the principal decisions with which we were concerned): in all other cases, appeal frequencies in the UK are much, much lower. Indeed, there are some strong arguments, for which the evidence in the consultation document provides *prima facie* support, that the level of appeals activity may in the past have been too low from a public policy viewpoint, rather than too high; although recent reforms to align with EU requirements may change that position in the future.

The low levels of appeals activity is manifest in Figure 3.2. The vast majority of decisions (well over 90% of the total), including Ofcom decisions, are not appealed, and Figure D5 indicates that a higher proportion of appealed decisions have not been over-turned than have been over-turned. Bearing in mind the scope for error in complex decisions, there appears to be nothing disproportionately large in these numbers and there is no sign of the existence of 'one-way bet' incentives or of eventuation

of the risk that the appeal body may become the second or *de facto* regulator 'waiting in the wings' (as it is put at paragraph 3.18 of the consultation document).

Although the consultation document notes that CAT judicial review decisions are on average taken significantly more quickly than its other decisions (paragraph 3.15), it also rightly recognises that the relevant types of decisions tend to be rather different in nature (e.g. a significant proportion of the JR decisions relate to merger activity where time is of the essence), and hence not necessarily closely comparable. The 'Other JRs' figure in Figure 3.3 is not noticeably lower than the merits review numbers shown, and our own investigations in Australia suggested that JR was not generally a quicker alternative, even ignoring the fact that in cases where the appellant succeeds matters are then remitted back to the regulator, leading to a potentially major extension of the time involved. Remembering also that merits appeals not infrequently involve consideration of novel or difficult issues, the six-month average length of appeal achieved by the CAT appears to us to be a level of performance that should not, at least by and of itself, give rise to major concerns.

Whereas the level of appeal activity in Australia increased significantly when the LMR regime was introduced, Figure 3.1 indicates that appeals activity in the UK has been relatively subdued in 2010-12 compared with the previous two years.

At 3.14 it is stated that:

"First, the more intense the review and the more widely the appeal body is able to review and in some cases retake a regulator's decision, the more incentive parties are likely to have to bring an appeal."

We are very strongly of the view this is the exact reverse of what both the Australian evidence and basic economic reasoning suggest is the case. It is also inconsistent with evidence on the frequency of appeals in UK telecoms price control cases, where the Competition Commission's assessment capacity has been more restricted than in other sectors. If the statement were right, it is to be expected that we would have seen (a) rather lower levels of appeals activity in UK communications than in other regulated sectors, and (b) much less appeal activity than has in fact occurred under the limited, error-based approach to merits review in Australian energy networks.

Similarly, we believe that the first conclusion at paragraph 3.32, to the effect that regulatory and competition appeals should be more focused on identifying material errors is directly and quite plainly contradicted by the Australian evidence, again for reasons that are readily explicable in terms of the relevant economics.

In conclusion

On the basis of our experience, we sense a danger in the consultation document that BIS might introduce measures that will systematically introduce the very problems that it says it is seeking to avoid and which, to the extent that they exist at all in current arrangements, occur in relatively narrow and easily identifiable areas of activities (e.g. telecoms price control cases), and are therefore readily addressable via targeted adjustments rather than across-the-board institutional change.

The Australian evidence indicates that it is the putting of undue constraints on those responsible for reviewing appealed decisions which causes a bias towards excessive levels of appeals activity. UK evidence appears to us to be consistent with this in that it is in precisely that area of activity (regulatory cases in communications) where the appeals process is most constrained that the statistics in the consultation document point to a problem (see Annex E for example).

There is also a rather fundamental issue underlying much of the detail, which we identified in our Reports and which requires some rather more radical thinking. As should be clear, we favour merits review because in its absence executive agencies (including regulators) are, in effect, able to exercise substantial market (monopoly) power without adequate checks and balances. It has not yet been possible to establish effective competition in the supply of regulatory decisions, and the best approximation to the disciplining effects of competition available is the possibility of challenge and adjudication. It is a relatively weak constraint, but valuable nonetheless, at least if the goal is better regulation.

Merits review sits on a fault line between executive decisions and judicial supervision, as indicated by the fact that in Australia the ACT is an *administrative* tribunal whereas in the UK the CAT is part of the judicial system – although we noted in our Reports that, in practice, the ACT operated very much like a court. When a merits review body substitutes its own decision for that of a primary regulator in a context where a number of decisions are possible (i.e. the issue is not binary) it is, in effect, making an executive (policy) decision. The judgment we came to was that the merits of decisions in such cases (non-binary) were best reviewed by another, independent administrative body, not by a judicial or quasi-judicial body.

In Australia we found three types of problems with the latter (judicial or quasi-judicial bodies dealing with complex cases that can lead to a range of possible decisions): inadequate resources for the assessment tasks; excessive focus on narrow legal issues that tended both to create one-way-bet incentives and to exclude due consideration of consumer interests and of policy objectives more generally; and potential vulnerability to undue influence by particular reviewers who could have rather fixed opinions about some relevant matters (e.g. about particular economic theories) and who, because of the small numbers involved in review, could introduce unwanted bias into decisions across a range of cases. To the extent that similar problems might exist in the UK they no doubt deserve some attention; but these are not matters that would be improved by the type of measures contemplated in the consultation document.

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11 September 2013

Notes

The Regulatory Policy Institute (RPI) is an educational and research charity dedicated to the promotion of the study of regulation for the public benefit. The views and opinions expressed in its documents are those of the named authors, not those of the RPI or of any other organisation.

The Hon. Michael Egan is Chancellor of Macquarie University, Chairman of Newcastle Coal Infrastructure Group Pty Ltd, Chairman of the Australian Fisheries Management Authority Commission, and Chairman of the Centenary Institute of Cancer Medicine and Cell Biology. He is a former Treasurer of New South Wales.

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